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Testimony of

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Subprime Mortgage Lending Problems in Context

Madam Chairman, Ranking Member Gillmor, and members of the Subcommittee, thank you for the opportunity to testify today. I am Alex Pollock, a Resident Fellow at the American Enterprise Institute, and these are my personal views. Before joining AEI, I spent 35 years in banking, including 12 years as President and CEO of the Federal Home Loan Bank of Chicago, and am a Past President of the International Union for Housing Finance. I have both experienced and studied many credit cycles.

As we all know, the great house price inflation of the past several years has topped out, and the unsustainable expansion of subprime mortgage credit which accompanied it has shifted distinctly into reverse. As many people have pointed out, the market is itself correcting sharply and rapidly, if belatedly. The subprime boom is over; the bust is here. Former enthusiasm has been replaced by large financial losses, the bankruptcy of subprime lenders, layoffs, accelerating foreclosures, fear, a liquidity squeeze—and of course recriminations, some well deserved.

What was recently seen as “creative” and “innovative” democratization of credit is now viewed as misguided and culpable bungling or worse.

Historical Patterns

All these elements of the current subprime mortgage lending bust display the classic patterns of recurring credit over-expansions. Such credit celebrations are based on optimism and a euphoric belief in the ever-rising price of some asset class, in this case, houses and condominiums, providing a sure-fire way to make money for both lenders and borrowers. They are inevitably followed by a hangover of defaults, failures, dispossession of unwise or unlucky borrowers, revelations of fraud and scandals, and late cycle regulatory and political reactions.

In the general pattern, nothing changes. You would think we would learn, but we don't. As the great student of financial behavior, Walter Bagehot, observed in 1873:

"The mercantile community will have been unusually fortunate if during the period of rising prices it has not made great mistakes. Such a period naturally excites the sanguine and the ardent; they fancy that the prosperity they see will last always, that it is only the beginning of a greater prosperity. … Every great crisis reveals the excessive speculations of many houses which no one before suspected."

We had a period of remarkably rising house prices. This stimulated the sanguine and ardent subprime lenders, and it stimulated the sanguine and ardent subprime borrowers. If the price of the asset is always rising, the risk of the loan seems less, and it appears that more leverage is always better. Booms are usually accompanied by a plausible theory about how we are in a "new era"; the subprime mortgage boom was no different.

It is essential to remember that the boom gets going because many people experience financial success. This so-far successful speculation is extrapolated. Subprime lenders were experiencing large profits and high stock prices. Subprime borrowers could get loans and buy houses they would otherwise be unable to and could benefit greatly from house price appreciation. A borrower who took out a 100% loan-to-value, adjustable rate mortgage with a teaser rate to buy a house which subsequently appreciated 30%, now had built substantial equity and the ability to refinance on more favorable terms. This was a successful outcome as a result of taking risk. But then somebody ends up buying at the top on a highly leveraged basis.

It is first success, and observing other people's success, which builds up the optimism, which creates the boom, which sets up the bust.

Home Ownership and Risk

The American home ownership rate has moved up to 69%. This was widely praised and is on balance a good thing. Some commentators have wondered whether this was not pushed too high, since home ownership is not for everybody. It is hard to say what the ideal home ownership ratio is.

The current American ratio is not particularly high on an international basis. According to an International Union for Housing Finance analysis, the U.S. ranks tied for 10th, 11th and 12th with Britain and Australia in home ownership among advanced economies. A number of countries maintain ratios greater than 75%. On the other hand Switzerland, a prosperous and pleasant country, has home ownership of only about 35%.

We can say that the mortgage market is constantly experimenting with how much risk there should be, how that risk is distributed, and how that trades off with success or failure. The subprime mortgage market obviously overshot on risk creation and is now paying the price. But if lenders and investors are free to take on credit risk, and if borrowers are free to take risk in order to have the chance to own a house, credit cycles are inevitable as these experiments proceed.

In general, it seems to me that if you want the long term growth, innovation and economic well being for ordinary people that only market experimentation can create, then you will have the boom and bust cycles that come along with market experimentation. I don't believe they can be avoided, except in hindsight.

Consider another notable experiment with mortgage lending: the creation of the long-term, fixed rate, amortizing mortgage loan. There is no doubt that this form of mortgage loan is highly attractive to borrowers. Introduced in the 1930s in response to the complete collapse of the mortgage market, it has been very successful in many ways.

But in the structure the 1930s set up to deliver this form of housing finance—namely the savings and loan industry—the long-term fixed rate mortgage was the basic cause of another complete and very expensive collapse: the savings and loan bust of the 1980s, which many of us remember vividly.

In economics, nothing is ever free. To preserve the fixed rate mortgage no longer provided by savings and loans in the 1980s, it was necessary to depend on vastly expanded securitization. Securitization typically breaks the link between the originator of the mortgage loan and who actually bears the credit risk. This usually results in riskier and less careful lending.

The financing engine of the subprime mortgage boom was securitization. This structure has greatly suffered, as is now clear, from just this break in credit decisions from credit risk bearing.

I believe that in an ideal mortgage finance system, the loan originator should always maintain a significant credit risk position in the loan, which creates a superior alignment of incentives-- this is always my advice to developing countries as they consider housing finance ideas. The subprime mortgage financing system is very far from this ideal.

Mortgage Risk

Mortgage finance has some very reliable systematic risk factors, and the subprime mortgage boom had all these risk factors operating together:

-Subprime loans have higher defaults and losses than prime loans

-Adjustable rate loans of all kinds have higher defaults and losses than fixed rate loans

-High LTV loans have greater defaults and losses than low LTV loans

-Periods of very rapid house price inflation result in greater defaults and losses than those of steady house price movements.

Current statistics reflect these risks. Subprime ARMs have 50% higher serious delinquencies than subprime fixed rate loans (9% vs. 6%). Subprime ARMs have six times the serious delinquencies of prime ARMs (9% vs. 1.45%) Prime ARMs have twice the serious delinquencies of prime fixed rate loans (1.45% vs. 0.7%).

The foreclosure rate on subprime mortgages of over 4% is below its recent peak of over 9% in 2000, but it is rising quickly. The subprime market is much larger than it was in 2000, having grown from about $150 billion to $1.3 trillion or over 8 times since then. So its economic and political impact is much greater.

The foreclosure rate for the oil patch mortgage loan bust of the 1980s peaked at 14.9% for the states of Arkansas, Louisiana, Mississippi and Oklahoma—an extreme experience used for stress tests by the bond rating agencies. If subprime mortgage foreclosures should approach this level, one analyst estimates losses to lenders of $100 to $150 billion and the loss of their homes by 1.5 million people.

It was not that subprime mortgage lenders did not understand these fundamental factors—it was that the risk reality outstripped the expectations of the models. As an old friend of mine says, "The model works until it doesn't." Perversely, the more everyone believes the model, and the more everyone uses the same model, the more likely it is to induce changes in market that make it cease to work.

Fraud

A risk difficult to model is fraud. Booms tend to induce fraud, misrepresentation and scandals. To quote Bagehot again:

> "The good times of too high price almost always engender much fraud."

Or the great economic historian, Charles Kindleberger:

"The propensity to swindle grows parallel with the propensity to speculate during a boom. The implosion of an asset price bubble always leads to the discovery of fraud and swindles."

The subprime mortgage boom is true to its type in this respect also. Of course, the fact that fraud and misrepresentation always occur does not mean they should be excused or tolerated. Integrity in describing the terms of a loan is essential.

As a sign of the times, National Mortgage News has introduced a new weekly "Fraud and Compliance Report," responding to what it calls "the explosion of mortgage fraud." Note, however, that it is often the lenders who are being defrauded.

Consider in this context the spread of "stated income" loans. The disastrous previous experience with this bad idea, then called "no doc" or "low doc" loans, seems to have been unfortunately forgotten. Such loans are an obvious temptation, or even invitation, to exaggeration of income in order to obtain the mortgage loan. Hence the now familiar name of "Liars' Loans."

Of late, subprime borrowers with defaulted loans have sometimes been referred to as "victims." In my view, however, anyone who lied about their income to get a loan hardly qualifies as a "victim." Perhaps the lie seemed a small thing compared to getting to buy the house whose price will always keep on rising.

What Should Be Done Now?

What should be done now? Late in the credit cycle, when losses are rising, credit is tightening, liquidity is disappearing and asset prices are already falling, regulators face a dilemma. The former mistakes and scandals are already clear, and they should respond somehow, but how to take action that is not pro-cyclical and will make the current problems worse?

In my view, the "Proposed Statement on Subprime Mortgage Lending" of the combined financial institution regulators is in general a sober and sensible attempt to balance these pressures. The credit and disclosure principles they expound seem to me prudent and basic banking, which is rightly combined-- in the Request for Comment--with concern about the risk of procyclical negative market effects because of the late cycle timing. How to achieve the final balance appears still open. As always, there is the further risk of a difference between carefully balanced words in a policy statement and their application by potentially overzealous field staff.

The proposed disclosure principles in general seem sound and fundamental. A good lender wants the borrower to understand what the loan agreement is. In particular, it is essential to disclose simply and clearly any prepayment penalties and the pattern of interest rate changes, if any, to which the loan is subject. I will say more about disclosure below.

I find it interesting that the proposed statement does not address down payment or LTV issues, since an equity stake in the house is an essential credit factor, and savings an essential economic factor. As one mortgage banker said recently, “Lenders will have to tell some borrowers to save for a down payment.” Imagine that! Perhaps mortgage finance needs to rediscover saving as a principle.

There has been recent discussion in Congress and elsewhere of the possibility of some kind of fund to refinance defaulted subprime mortgages. The FHA is often mentioned in this context, although it is a credit insurer, not mortgage investor. Also, its delinquency rate is at the same level as the subprime sector, which suggests that loosening its credit standards further may not be the best idea. And we should certainly not be bailing out subprime lenders and investors—they should be on their own.

In considering this issue, I have been able to find one historical precedent: the Home Owners’ Loan Corporation (HOLC), created by the Home Owners’ Loan Act of 1933. In the midst of the housing finance system collapse of that time, the Act was to “protect the small home owner from foreclosure and relieve him of part of the burden of excessive interest and principal payments.” Giving its bonds in exchange for defaulted mortgage loans, it provided refinancing for about 20% of U.S. mortgages. HOLC ended up itself foreclosing on about 20% of its own loans. Upon liquidation in 1951, it returned a small surplus to the Treasury.

Of course, our problems of today do not begin to approach those of 1933. But I suggest that HOLC could be usefully studied by anybody thinking about this issue.

The One-Page Disclosure

When considering borrowers in financial trouble, whether from unwise borrowing, not having understood their risks, having been fooled, or even induced into loans by misrepresentation, there is a natural desire to try to protect them.

I believe the superior strategy is to equip them to protect themselves, by ensuring short, simple and clear disclosures of mortgage loan terms. Most of us have had the experience of being overwhelmed and befuddled by the huge stack of documents full of confusing language in small print presented to us at a mortgage closing, which result from legal and compliance requirements, including regulatory attempts to insure disclosure.

I would like to see the design of a one page form which gives the essentials of the loan, which would be given to every mortgage borrower a week before the closing. This page should contain the following:

- Amount of loan

-LTV ratio

-Final maturity

-Prepayment fee, if any

-Balloon payment, if any

-Points and closing costs

-Initial rate on loan in % and monthly payment in dollars

-How long this rate is good for=when higher rate starts

-Fully indexed rate on loan in % and monthly payment in dollars

-Your household income on which this loan is based

-Initial monthly payment as % of income, and payment plus taxes and insurance as % income

-Fully indexed monthly payment as % income, and payment plus taxes and insurance as % income

-A name, number and e-mail for you to contact with any questions

-An authorized signature of the loan originator

-The signature of the borrower.

As I said, a good lender wants an informed and understanding borrower. Just as you get a prospectus for an investment, you should have to get a one page form something like this before you enter a mortgage loan agreement. But this page must be something simple and clear: 90% of the relevant information which is clear and understandable is better than 100% which is complex and opaque.

Thank you again for the chance to be here today.